DOW THEORY LETTERS INC.

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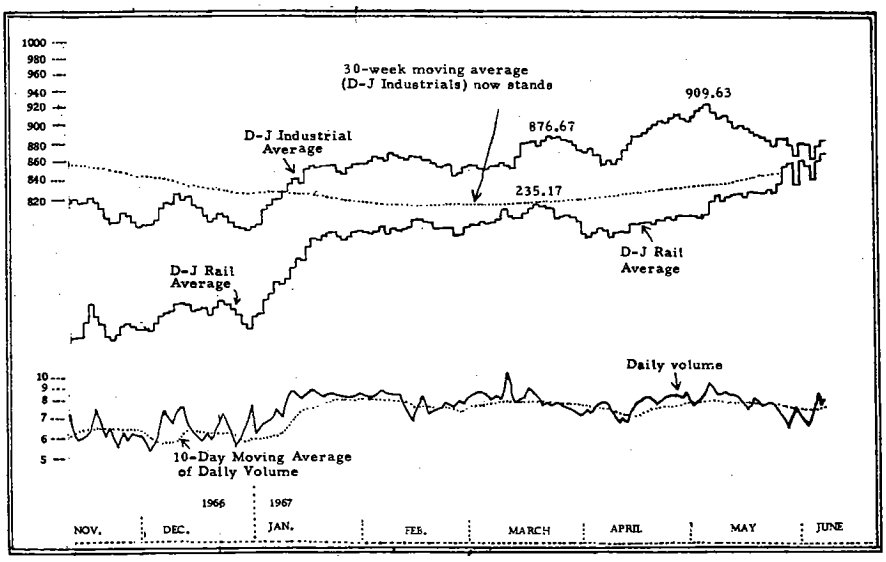
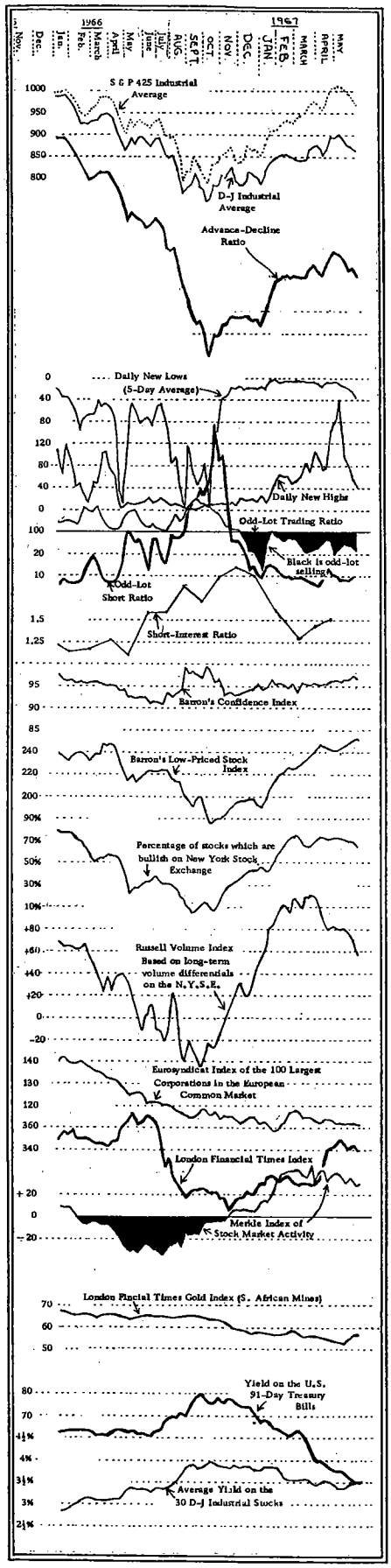
THE MARKET: According to the old market adage, those who wish to be successful on Wall Street would do better to follow the advice of a psychologist rather than an economist. In this market, perhaps the most success would be obtained by seeking a mystic who was able to see into the minds of the world's leaders. With Israel and the Arab world locked in a war which nobody seriously believed would happen, who knows what goes on in the minds of Lyndon Johnson, Nasser, and the leaders of Russia, China and the other affected nations of the world.

For many months I have been writing in my "Notes & Quotes" column that I felt LBJ was tramping down the road to disaster. In confrontation after confrontation, from Suez to Cuba, the Communists have backed down. When a loser comes up with a good hand, he is liable to bet the "whole pot." Russia finally came up with a "straight flush," she backed the Arabs in their age-old "holy war" against little Israel. Yet it is obvious that Russia did not expect a real shooting affair; it was a power play calculated to "shake" the U.S. and make her comprehend what pressures could be set against her if she continued to escalate the bombing in North Vietnam.

But anyone who knows anything of Arab temperament must have had a sinking feeling as they studied the situation. Anyone who watched the late newsreels from Cairo showing thousands of Arabs shouting, "We want to go to Israel, we want to go to Israel," must have had second thoughts on the possibility of a peaceful settlement of the Mid-East. The pressure of events, the pressure of massed armies facing each other finally exploded on June 5. The Arab-Israel confrontation erupted into violent war in a matter of hours.

Events are happening too fast for anyone to write with authority about "what will occur" in the days and weeks ahead. Nevertheless, a few facts are clear. From a potential position of splitting the Communist world (Russia and China) in two, the U.S. has driven the two great Communist powers together (at least from the practical standpoint). And the U.S. has backed itself into a most serious position. I did not know exactly how this situation would develop, but I was not one of the group which claimed that "all was a bluff" on the Arab-Israeli front. I have stated repeatedly that President Johnson had produced the formula for potential disaster. When sparks are flying in all directions, who can be certain that there will not be two fires, three fires, four fires? I am a luke-warm Walter Lippman fan, but I agreed with him when he wrote, "The root of his (Johnson's) troubles has been pride, a stubborn refusal to recognize the country's limitations or his own limitations....Such pride goeth before destruction, and an haughty spirit before a fall."




S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index
Based on long-term volume differentials on the N.Y.S.E.
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fincial Times Gold Index (S. African Mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

From the standpoint of the Dow Theory, as explained in the last Letter, the primary trend of the market and the economy is down. It turned down in February, 1966, when at 995.15, the great bull market fully discounted the best that could be seen ahead. When one climbs the highest mountain and finally reaches the peak, there is no place to go but down. So it is at the peak of the bull tide. From here on, subject to periodic periods of rally in the market and hopes in the minds of investors, the way off the mountain is down. At the bottom of the mountain the investor will rest, take account of his inventory, nurse cuts and bruises received on the descent, and then (if he is a true mountain climber) prepare for an assault on the next peak.

But those who are not real climbers, the amateurs and hangers-on, the thrill seekers, they will be very apt to have "had it" with mountain climbing. Perhaps a broken bone or a broken spirit will end their mountain scaling forever. It will remain for the students of mountains, the professionals, to keep body and soul together in preparation for the next ascent. So it is with investing. The true students will come out of this bear market with bank account intact, perhaps in better shape than ever to enter the next bull market. But the amateur market crap-shooter, the Johnny-come-lately and the rumor-players, they are the ones who will be most likely to have had it with Wall Street. The bear market will break their spirits and their wallets. They will have learned nothing, but they will be first in line to shout about the "Wall Street wolves" and the immorality of the market. It has happened before; it will happen again.

NOTES & QUOTES: Even those who overestimated the army of little Israel and underestimated the capabilities of the Arab armies were flabbergasted. In a little over three days the Israeli air force assumed full supremacy of the skies while their armored columns raced almost at will over the Arab lands. On June 7 a stunned and embarrassed Russia joined the U.S. in asking for peace. Russia had given the Arabs no direct help. Instead, she had to watch as half a billion dollars worth of Russian-made Arab hardware went up in flames. The U.S., which had given the Israelis no help, breathed easier as it became clear that Israel could handle the whole Arab world alone.

Yet the full story has not yet been told. Nasser has lost face, but if he can hold his position regardless of the Arab disaster he will be harder to deal with than ever. Other Arab leaders too will have to move towards the exits as the Arab populace broods over the "bill of goods" they have been sold regarding their "military capabilities." Certainly, the value of Mid-East oil reserves can be lowered many notches, regardless of which way the war goes. The Mid-East is bound to be in a state of ferment for months or years after this war has ended.

Russia has lost some prestige in the eyes of the Arab world; yet the Arabs have no major power but Russia to turn to. Arab-U.S. diplomatic relations have now been severed, and thus the work of years and the "power" of billions of Yankee dollars have slid down the drain.

As far as Israel is concerned the U.S. has lost prestige in her eyes, but it is nevertheless doubtful whether the U.S. would have kept out of the war if Israel was losing. On the balance sheet, both the U.S. and Russia have lost Mid-East prestige, but the U.S. came out by far the loser. Russia now has a much clearer entrance into the power sphere of the Arab world; she is clearly the "big brother" to whom the Arabs will turn when the war is over and they return to mending their battered armies. The U.S. on the other hand will find the Arab world a far harder place to deal with, while the "price" which will have to be paid (both by the U.S. and by U.S. oil interests) cannot yet be known. If Russia has anything to say about it, the price is going to be a whopper. For denial of oil to the West has been a Russian goal for years.

One thing has been made patently clear by the Mid-East war. Neither Russia or the U.S. is desirous of a direct confrontation. Therefore, whatever trouble the U.S. can expect from Russia in the future is probably going to come in the form of proxy-confrontations through a second or third power. The most likely next spot, Greece and a possible civil war there. I agree with Eliot Janeway: Russia did not want or foresee the Arab-Israeli conflict. But if war comes to Greece, it will be a much more calculated and planned effort on the part of Russia.

If subscribers don't think it bothers me to write this way—well, they're just wrong. I am writing in this vein in an attempt to get all my readers out of this bear market. I know from experience that charts and technical lingo alone do not suffice to get all subscribers to act. It is necessary to appeal to both emotions and reason in this business. Reason does appeal to many of my clients, and I have applied it. I have included charts showing how speculation was rampant in 1966 just before the collapse, how speculation was even more rampant (see last Letter) during the 1967 bear market recovery. I have published charts showing how values were almost non-existent (Letter 358) during 1966 and 1967, and I have warned readers not to take bull market technical studies (short interest, odd-lots, debits and credits) as necessarily meaningful during a primary bear market. For those who act on emotions, I have tried to show how serious the Vietnam path was, how the monetary crisis was entering the boiling stage, how this nation was using up its assets in debt, war production and Great Society adventures.

Above all I have attempted to convince my subscribers that when the Dow Theory signals a turn in the tide, the market is not worth fooling with. This is particularly true during the deceptive second phase of a bear market when the unwary speculator is most apt to be drawn into the maelstrom. Bullish hopes die slowly during a bear market, but in the end they do die. Sometimes it is the market itself which crushes the hopes, sometimes it is economic or world events, sometimes all three.

The true tragedy of a bear market is usually demonstrated in two ways: Most dramatically by a crash in values such as occurred in 1929 or in 1937. Less dramatically by grinding attrition and hopelessness as was the case in 1932 or in 1942 (or even in 1949). So far, this bear market has yet to produce either of these tragic situations. Neither may materialize, but if we are (as I am convinced we are) in a primary bear market then all the odds point to the ultimate appearance of both events. I feel that the crash phase of this bear market (1966 did not produce a real crash) could well come before 1967 is out. I believe it may be a year or so after such a crash before a depression will blanket the country. Those who believe this will prepare for it. The great majority, who do not for a moment think we are in a primary bear market, will probably suffer with the market as stocks sink to progressively lower levels.

On May 29 the D-J Utility Average broke to a new 1967 low. This type of divergent action (i.e. a new low during a rally) is hardly the type of action one should expect during a true primary bull market advance. In fact, a study of the past few decades indicated that the Utility Average has tended to lead rather than lag the rest of the market. Therefore, I took the new 1967 Utility low as one more sign of the "sickness" which lurks in the foundations of the 1967 advance. Furthermore, I have shown on numerous occasions how, when the D-J Utility and the D-J 40-Bond Average are in a declining trend, it is generally bearish for the whole Wall Street picture. Letter 357 drew particular attention to this situation in Utilities and Bonds, and subscribers might want to go back and review the chart and the warning in that Letter.

On June 5 (when war broke out between Israel and the Arabs) the market was treated to one of the worst days of downside compression in history. On that day a spectacular 1211 issues declined while only 112 advanced. This action knocked the advance-decline ratio down to its lowest level since February 4, at which time the Dow was in the 835 area. At this writing, there is no doubt but that the market is in a heavily over-sold condition; nevertheless, in due time I expect to see the Dow confirm the break in the A-D ratio and sink first into the 835 level, then below 800 for a test of the 1966 low of 744.

As I see it, the Dow is still better than 100 points above the 1966 low, but in almost every area the situation is worse than that which existed in 1966. The war in Vietnam is hotter, war losses are greater, the Mid-East is at war, the U.S. deficit is ominous, the monetary situation is more serious, the domestic (non-war) economy is sloppy, a tax rise is almost certain, industry is suffering from a profit squeeze, inventories are still unwieldy, and in the face of all this, speculation in the market has been rampant. In fact, the wild gyrations of the market in the face of crisis and speculation reminds me more than anything else of a sort of "nervous breakdown" on Wall Street, Rails going one way, Industrials and Utilities the other, speculation running into the stone wall of reality. All of which, I suppose is part of the deceptive second (psychological) phase of the primary bear market. The major trend of events is not yet clear for the markets. When the vision clears, it will be seen to be down.

COMPOSITE CHART CHANGES: I have made a few changes on the composite (page 1) chart. I have eliminated the Barron's up-tick and down-tick ratios. I have found this index (which I developed) to be of little or no use in forecasting market movements. I have also removed the 10-day averages of advances and declines. That index was to show areas of buying and selling pressure, but I believe that my new indicator will show this better and with far superior "leading characteristics."

This new index, which for want of a better name I have labeled the Russell Volume Index, is shown on the current page 1 chart. I have experimented with volume indices for over fifteen years. There is much validity in the claim that "volume tends to precede price." Joe Granville has done a good deal of work on this idea, and from it stems his whole concept of "On-Balance-Volume."

However, I have had most success with volume differentials on the N.Y.S.E. as an indicator of coming price movements. Rather surprisingly, I have found that long-term differentials of total upside and total downside volume have provided the best results, mainly for indicating intermediate-term and long-term changes in price. I am not at liberty to disclose exactly how the Russell Volume Index is arrived at, but suffice it to say that this index provides long-term (over two-months) tabulations of the direction of upside and downside volume totals on the N.Y.S.E. I have followed this index for years, and it has been extremely valuable. In fact, I mentioned it prominently in Letter 356 (April 28) when I said that "I believe the peak of strength has been seen for this advance."

The amplitude of the Russell Volume Index is not as important as its direction. As far as amplitude is concerned, the Index has dropped under zero only three times since 1961. When the Index drops under zero, it is indicative of extreme pressure. The three under-zero readings occurred in 1962, for six weeks in 1965, and finally (as shown) during the 1966 bear-market decline.

The Russell Volume Index is forecasting when, following a long rise or decline, it reverses decisively in the opposite direction. Note the base formation and reversal of August, September, 1966. This was followed by an extended rise of the Index into very high territory in 1967. During the last week of March, 1967, the Index again reversed—this time to the bear side. Since then the Index has dropped precipitously, having zig-zagged down over the past month. In this latest case the Index gave its bearish signal almost five weeks ahead of the 909.63 (May 8) peak on the Dow. As long as the Index continues to drop to successive new lows, it is forecasting a deteriorating technical situation for the market. If the Index drops below zero we can be sure that at that time the market will be under conditions of the most severe selling pressure (usually a "crash" phase in the market).

CRITICAL AREA: Back in Letter 353 I presented the accompanying chart (see page 4) and drew attention to the "870-900 congestion area." This is the area (shaded section on chart) in which distribution took place on the rally just prior to the final frightening plunge to the 1966 lows.

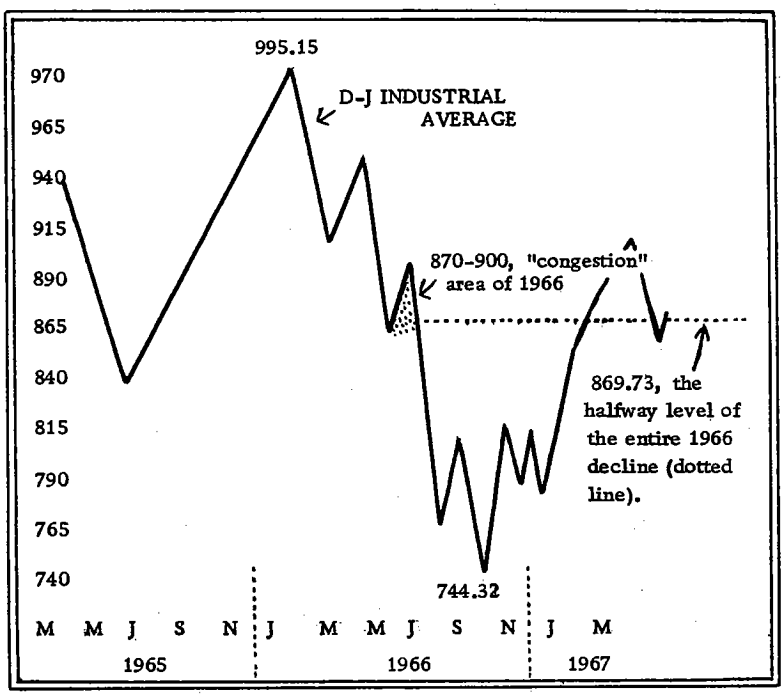
During 1967 this same area has again proved a major obstacle to the recovery in the D-J Industrial Average. In early May, 1967, the Dow pushed temporarily above the 870-900 area (to the high of 909.63). This occurred under the guise of frantic speculation in the glamour and low-priced section of the list. The recovery above 900, however, was short-lived. By May 29 the Dow had plunged below the 50% level of the entire 1966 decline or below the 869.73 level (dotted line on chart). By May 31 the Industrials had dropped to a low of 852.56.

A new rally got underway, probably impelled by the tremendously "oversold" conditions which prevailed at the 852.56 low. The question on everyone's mind is—will the new recovery take the Dow above the May 8 high of 909.63, or has the market been tracing out the beginning of the next broad decline in the bear market, a decline which will ultimately take the Averages below the 1966 lows?

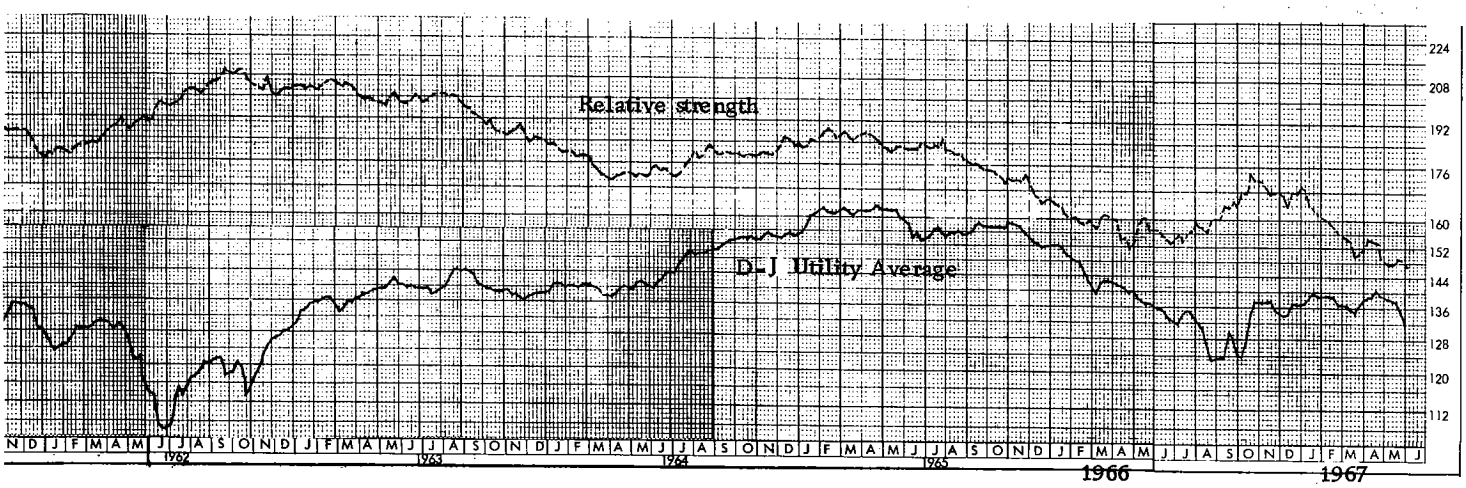
My own guess is that the May 8 peak of 909.63 was approximately the top of the 1967 retracement. If the war in the Mid-East ends suddenly and satisfactorily, it is possible that a sudden burst of enthusiasm might take the Dow temporarily above the 909.63

 level, but I doubt it.

A study of the chart indicates that a tremendous amount of stock has been distributed so far in this bear market, first in the high area of 1966, then in the 870-910 area of 1967. Volume in both of these zones was of record-breaking proportions. Many stockholders have been locked in and are now sustaining losses. Others are still coming in, hoping to make a belated "killing." Such buying, in the treacherous, second phase of the bear market constitutes the sheerest form of financial recklessness in my opinion.



UTILITIES: Although there was no Utility Average in Charles H. Dow's day, statistics for a D-J Utility Average were introduced to the public in January of 1929. A study of this Average indicates that it is most useful for predictive purposes. Most utility issues seem to have a long-term "growth factor" built in, the growth being the expanding population in each company's servicing area (plus the fact that individual consumers tend to use more electricity over the years). Since most utility issues present a well-protected dividend picture, these stocks sell to



some extent as "bonds". They therefore tend to fluctuate with money rates and the bond market.

From our standpoint, however, it is perhaps more important to visualize the Utilities as being a fair indicator of high-grade investment sentiment. Historically, the action of the Utility Average has tended to precede the action in the other two D-J Averages.

As seen on the chart, the Utilities "bottomed out" in early 1962, a full five months before the bottom in the Industrial Average. The Utility Average started running into important trouble around March-April-May, 1965. By the end of 1965 it was obvious that the Utilities were not going to better their earlier high, despite the new highs on the Dow. The November-December, 1965 break-down in Utilities was a bad omen for the market. Two months later (February), the Industrials topped out and the bear market was on.

The 1966-67 rally for Utilities was a half-hearted affair. Utilities formed a "double-top" during 1967 in the 140 area. By late May, 1967, Utilities had broken below two preceding bottoms to record a low for the year. On June 5 the Utility Average hit a closing of 131.71, the lowest level since October, 1966. In my opinion, this is hardly a hopeful indication for the general market.

I believe the current status of the relative strength line on the Utility Average is interesting. Last week Utility relative strength (action relative to the entire market) sank to the lowest level in 8 years. If Utilities afford an insight into the sentiment of high-grade investment funds, the picture is decidedly cloudy ahead. (Utility group chart courtesy of Traders Research, 101 Cherry St., Alton, Ill. 62003).